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JAMES H. McKENNEY,

Supreme Court of the United States.

No. 141.

WINFIELD S. GREGG, *Petitioner*,

vs.

THE METROPOLITAN TRUST COMPANY et al., *Respondents*.

BRIEF ON BEHALF OF WINFIELD S. GREGG, PETITIONER.

STATEMENT OF THE CASE.

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STATEMENT OF THE CASE.

This case comes into this court on writ of certiorari from the United States Circuit Court of Appeals for the Sixth Circuit.

In a suit to foreclose a first mortgage for $2,000,000, and a second mortgage for $7,456,000 on the Columbus, Sandusky & Hocking Railroad, Winfield S. Gregg was an intervening petitioner to the amount of $6,804.49, for ties and other current supplies furnished the railroad for its maintenance and operation from day to day as a going concern (Rec. 34). The claim is described in the record and admitted by the parties to have been one

"For materials and supplies, and was necessarily incurred and grew out of the operation and maintenance of said railroad as a going concern from day to day, and was a necessary operating expense in keeping and using said railroad

and preserving said property in a fit and safe condition as such." (Rec. 102, 104, 145, 148.)

The Columbus, Sandusky & Hocking Railroad Company had defaulted in the interest on its first-mortgage bonds due April 1st, 1896, October 1st, 1896, and April 1st, 1897, but nevertheless had been allowed to continue to operate the road (Rec. 153, 202).

A receiver was appointed in the foreclosure suit on June 2d, 1897, at the instance of The Mercantile Trust Company trustee of the first mortgage. (Rec. 22.)

Most of the supplies referred to had been furnished in the month of May, 1897, and on the 1st, 2d, and 3d days of June, 1897. (Rec. 145.)

When the receiver took his inventory on the 10th of June, 1897, $3,200.00 worth of these supplies, viz: ties, were found to be on hand. (Rec. 146.)

The claim was presented to the receiver as a six months' supply claim under the order appointing the receiver and was allowed as such. (Rec. 23, 24; 146.)

It was also presented to and allowed by the Circuit Court as a six months' supply claim within the terms of the order originally appointing the receiver, but so far as it was sought to have it declared a lien on the corpus of the property and paid out of the proceeds of the sale thereof, it was disallowed; (Rec. 133, 175, 176); also so far as it was sought to have it declared a lien on the corpus of the property to the extent of $3,200.00, by reason of the fact that supplies to that amount had been furnished at a time when the Railroad Company had defaulted in its interest for over a year, knew it was insolvent and had no intention of paying therefor, which supplies had come into the hands of the Receiver and had been used by him for the benefit of the property, it was likewise disallowed. (Rec. 146, 175, 176.)

On appeal to the United States Circuit Court of Appeals

(Gregg vs. Mercantile Trust Co. et al., 109 Fed. 220) the decree of the lower court was reversed upon a question as to whether or not there had been a diversion of current earnings. (Rec. 195.)

The Circuit Court found that there had been a diversion of earnings but also a restoration thereof sufficient to make good the diversion and again dismissed the claim, so far as it was sought to have payment thereof from the corpus of the property, or so far as the special equity was claimed to the amount of $3,200.00. (Rec. 235, 257, 319.)

The Circuit Court of Appeals affirmed this decree and reiterated its prior decision in which it had held:

"That preference could be given to such claims only out of the income of the mortgaged railroad and that mortgages upon the corpus could only be displaced by such creditors when it was shown that there had been a diversion of the income either before or after the receivership by which the mortgagees had profited." (Gregg vs. Mercantile Trust Co. 109 Fed. 220, 227.)

The court said:

"The proceeds of the sale of the mortgaged property is insufficient to pay the mortgage debts, and if the appellant is to be paid at all he must be paid at the expense of the mortgage creditors out of the proceeds of the sale of the mortgaged property.

"Before the mortgage creditors can be displaced in respect of the corpus of the property it must appear that the current earnings which accrued during the period shortly before the receivership were not applied to the payment of current operating expenses, incurred within the same period, but were used in the permanent improvement of the property mortgaged or for the payment of the mortgage debt, and that as a consequence of this misapplication current expense creditors have been disappointed. This is the well settled rule in respect of the payment of these so-called preferential debts of the income. Central Trust Co. vs. East Tenn. V. & G. Ry. Co., 26 C. C. A. 30; International Trust Co. vs. Townsend

Brick Co. 37 C. C. A. 396; Rhode Island Locomotive Works vs. Continental Trust Co., 47 C. C. A. 147.

"This was the law as declared in the opinion upon the former appeal and as such is the law of the case. Gregg vs. Mercantile Trust Co., 109 F. R. 220, 227." (Rec. 348.)

The mortgaged property realized at the sale only sufficient, after paying costs, receivers' certificates, and accrued interest, to pay the first-mortgage bondholders a little more than fifty cents on the dollar (Rec. 330).

FIRST POINT.

The diversion of current earnings for the benefit of the first mortgage bondholders was not a condition precedent to the payment of Gregg as a supply claimant out of the proceeds of the sale of the mortgaged property.

In deciding the contrary the Circuit Court of Appeals for the Sixth Circuit was not only in irreconcilable conflict with its own prior decisions but also with the decisions of the Circuit Courts of Appeal for the First, Fourth, Eighth and Ninth Circuits and the decisions of this court.

(a) It had first formulated the doctrine applicable to such claims in Central Trust Co. vs. East Tennessee, V. & G. R. Co., 80 Fed. 624, where it had said (page 626):

"But, independently of any diversion of current income, there is a class of debts, incurred in maintaining the operation of a railway, which, under special circumstances, and subject to very positive limitations, has been held to outrank, in priority of payment, contract liens."

And after discussing

Miltenberger vs. Railway Co., 106 U. S. 286-311;
Burnham vs. Bowen, 111 U. S. 776-781;
Kneeland vs. Trust Co., 136 U. S. 89-97;
Thomas vs. Car Co., 149 U. S. 94-117,

had summarized the law as follows:

"From these cases it may be deduced that in respect of railroad mortgages there is an implied agreement that all proper operating expenses of such companies, while under control of the mortgagors, are to be paid out of current receipts, and that any diversion of such income by which current operating expenses are left unpaid is a misappropriation of the income, and upon a proper showing the mortgagees receiving the benefit will be required to reimburse the fund applicable to the payment of these 'debts of the income' to the extent of the diversion. It may further be deduced that, independently of any diversion, the necessary operating expenses of a mortgaged railroad, constituting a first charge upon the income while under the control of the mortgagor, will continue to be a charge upon the income under a receivership, and, if necessary, upon the corpus of the property. This latter equity is supposed to arise from the nature of the public duties resting upon such companies, and upon the necessity of such expenditures in preserving the property as a going concern for the ultimate benefit of the mortgage creditors."

This was the law of the Sixth Circuit when Gregg furnished the ties in question in May and June, 1897, at a time when the Railroad Company was insolvent and had defaulted in the payment of interest on its bonds. It is a fair presumption that he relied upon the security of the corpus in furnishing this material. It is inconceivable that he would otherwise have done so.

Despite this decision, which was rendered in 1897, the same court, in 1899, while the case at bar was pending in that court, said, in International Trust Co. vs. Townsend Brick & Contr'g Co., 95 Fed. 850 (page 860):

"The power of the court to displace mortgage liens in favor of such unsecured debts of the mortgagor depends upon the fact that the current income, either before or after the receivership, has been diverted to the benefit of the displaced mortgage, and the extent to which the corpus of the mortgaged property can be called upon to pay such debts of the income is limited by the amount of the diversion."

In Rhode Island Locomotive Works vs. Continental Trust Co., 168 Fed. 5, 7, this general rule was again stated.

In both of these cases, however, the claims seeking priority were held not to be "current supply claims" or "debts of the income." The two decisions, at total variance with the prior case, were purely *obiter* in reference to the question whether the claims were payable out of the proceeds of the sale of the mortgaged property. For in International Trust Co. vs. Townsend Brick & Contr'g Co. (*supra*), the bridge, for the payment of which priority was sought, was held to be a permanent betterment; and in Rhode Island Locomotive Works vs. Continental Trust Company (*supra*) the locomotives, for which payment was sought, were found to have been purchased on the general credit of the company, and not in the expectation of being paid for out of current earnings.

But on the first appeal of the case at bar (Gregg vs. Mercantile Trust Co., 109 Fed. 220), while the claim was found to be one for current operating expenses absolutely necessary to enable the railroad to continue as "a going concern," and "in every respect a highly meritorious one," the court followed its *dicta* in the last two cases, contrary to its prior decision in 1897, although it declared (page 229):

"We are aware of the fact that in maintaining the necessity for evidence of diversion of income before allowing solemn mortgage securities to be displaced we are in disagreement with other courts of appeal, for whose judgment we entertain very great respect. Believing, as we do, that we have correctly interpreted the opinions of the Supreme Court, and that the limitations which have been placed upon the preferential character of unsecured operating debts are in accord with settled principles of justice, we shall adhere to the views we entertain until the Supreme Court shall otherwise adjudicate."

(b) The Circuit Courts of Appeals referred to in this statement are as follows:

First Circuit—

In the Circuit Court of Appeals for the First Circuit in the case of New England R. R. Co. vs. Carnegie Steel Co., 75 Fed., 54, Judge Putnam said, pages 58, 59:

"The petition sets out no special circumstances to distinguish the claim from an ordinary current supply bill, or to entitle it to a lien on the corpus of the mortgaged property. It states enough, in connection with what we have already explained, to entitle it to the usual order for payment by the receivers, and consequently by the purchasers referred to. Therefore, as it ranked only as an ordinary current supply bill, could the court give it priority over the mortgage in question on the corpus of that portion of the property as to which the corporation had absolutely parted with all power of disposal except subject to the mortgagee's title? Whatever might be our decision if the case was of novel impression, we think we are concluded by Miltenberger vs. Railway Co., 106 U. S. 286, 292, 293, 295, 298, 302, 304, 308, 311, as explained, and perhaps limited, in Kneeland vs. Trust Co., 136 U. S. 89, 96, 97; Thomas vs. Car Co., 149 U. S. 95, 110, 112; Bound vs. Railway Co., 7 C. C. A., 322, 58 Fed. 473, 480, and Finance Company of Pennsylvania vs. Charleston, C. & C. R. Co., 10 C. C. A. 323, 62 Fed. 205, 208. We are therefore required to hold that the circuit court had the power to give the priority complained of to supply bills of the character, contracted at the time and remaining unpaid, under the circumstances shown in reference to those now at issue. What would have been the conclusion if the trustees of the second mortgage had not asked for a receiver and had not submitted to the order of September 8, 1894, modifying to some extent the then existing receivership, and thus giving it retroactive effect as of the time of its original creation, we need not determine. So far as we have discovered, Miltenberger vs. Railway Co. is the only instance in which the Supreme Court has in fact allowed accrued supply bills a priority against the corpus of mortgaged property; and, as we understand that suit, the circumstances of the case at bar in its final stages are substantially the same for our present purposes, and we have followed strictly its conclusions without going beyond them."

This case affirmed the lower court, which had held in Wood vs. New York & N. E. R. R. Co., 70 Fed. pp. 741, 743—

"that independently of the question of diversion, debts may be preferred which are incurred for labor and supplies necessary to keep the road a going concern from day to day, or which are the outcome of indispensable business relations, a continuance of which involves the interests of the public and the traffic of the road."

Fourth Circuit—

In the Circuit Court of Appeals for the Fourth Circuit, in the cases of Finance Co. vs. Charleston, C. & C. R. Co., 62 Fed. 205—where it affirmatively appeared that the earnings of the railroad company were never sufficient to pay operating expenses—it had been held, speaking through Mr. Justice Fuller:

"It must be regarded as settled that a court of equity may make it a condition of the issue of an order for the appointment of a receiver of a railroad company that certain outstanding debts of the company shall be paid from the income that may be collected by the receiver or from the proceeds of sale; that preferential payments may be directed of unpaid debts for operating expenses, accrued within ninety days, and of limited amounts due to other and connecting lines of road for materials and repairs and for unpaid ticket and freight balances, in view of the interests both of the property and the public, that the property may be preserved and disposed of as a going concern and the company's public duties discharged; and that such indebtedness may be given priority, notwithstanding there may have been no diversion of income, or that the order for payment was not made at the time and as a condition of the receiver's appointment, the necessity and propriety of making it depending upon the facts and circumstances of the particular case and the character of the claims (Miltenberger vs. Railroad Co., 106 U. S. 286, 311; Trust Co. vs. Souther, 107 U. S. 591, 594; Union Trust Co. vs. Illinois M. Ry. Co. 117 U. S. 434; Morgan's L. & T. Railroad & Steamship Co. vs. Texas Cent. Ry.

Co. 137 U. S. 171; Kneeland vs. Foundry Works, 140 U. S. 592). Of course the discretion to enter such orders should be exercised with great care, but as late as Thomas vs. Car Co., 149 U. S. 95, 110, the Supreme Court quoted the remarks upon the doctrine and its proper application in Miltenberger vs. Railroad Co., *supra*, with approval, although, as observed by this court in Bound vs. Railway Co., 58 Fed. 473, 7 C. C. A., 322, the tendency of that case was to narrow the limits within which an equity court should confine itself in making such allowances."

In the case at bar it was a provision of the order appointing the receiver, made at the instance of the trustee of the first mortgage, which is now resisting and so far has successfully resisted this claim, that "claims for wages, services, materials and supplies due and to become due" be paid from the proceeds of receivers' certificates charged on the corpus of the property (Record, 23), and some of them were paid (Record, 27, 32).

Eighth Circuit—

In the Circuit Court of Appeals for the Eighth Circuit, in the case of St. Louis Trust Co. vs. Riley, 70 Fed. 32, the court said (pages 36, 37):

"From this brief review of the decisions of the Supreme Court bearing upon this question, we think these propositions may properly be deduced:

"First. There are certain claims against a mortgaged railroad company, accruing before the appointment of a receiver, which are entitled to preference over a prior mortgage debt in payment out of the earnings of the railroad during the receivership and out of the proceeds of the sale of its property.

"Second. It is an indispensable element of every such claim that it is founded upon property furnished or services rendered to the mortgagor which either preserved or enhanced the value of the security of the mortgage debt, and thereby inured to the benefit of the mortgagee.

"Third. Claims of this character have been given a preference over the mortgage debt by these decisions on one of

two grounds—either on the ground that the mortgage is a lien on the net, and not on the gross, income of the railway company, and where that part of the income that is applicable to the payment of current expenses of operation, proper equipment and necessary improvements has been diverted to pay interest on the mortgage debt or to otherwise benefit the security, and this diversion has left claims for these expenses unpaid, it is the province and duty of the chancellor to restore the earnings of the diverted fund by taking an equal amount from the railway company during the receivership and applying it to the payment of these claims in preference to the mortgage debt (Fosdick vs. Schall, Burnham vs. Bowen, St. Louis, A. & T. H. R. Co. vs. Cleveland, C. C. & I. Ry. Co., Railroad Co. vs. Hamilton, Morgan's L. & T. R. S. S. Co. vs. Texas Cent. Ry. Co., supra); or on the ground that the payment of the claims is necessary to preserve the mortgaged railroad, and to keep it a going concern. It is indispensable that the operation of a railroad be uninterrupted in order that the travel and traffic of the public may be accommodated, and in order that the franchises of the railroad company may be preserved from forfeiture. Hence, the wages of employes, who might otherwise cease from their work; the amounts due to connecting lines of railroad that might otherwise cease their business relations with the managers of the mortgaged property, and the claims for supplies and materials necessary to keep the mortgaged railroad a going concern, may, in proper cases, be paid out of the earnings during the receivership, or out of the proceeds of the sale of the mortgaged property, in preference to the mortgage debt."

And in Central Trust Co. vs. Clark, 81 Fed. 269, the same court said, in reference to this class of cases (page 271):

"It thus appears that within less than thirty days after the gear wheel and pinion had been delivered by the Midvale Steel Company and placed in operation, the railway company mortgaged the property so acquired, along with its other property, and used the proceeds of the mortgage to meet its interest obligations to the first and second mortgage bondholders. In view of these facts, we think, as be-

fore stated, that the intervenor's claim was of such a nature that a court of equity having in charge the administration of the fund realized by the sale of the mortgaged property was fully justified in according it a preference, and in directing its payment before any distribution of the proceeds of the sale was made among the mortgage bondholders. The circumstances under which the indebtedness in controversy was contracted were such as to bring the case fully within the doctrine which was stated by this court, after a full review of all the decisions, in Trust Co. vs. Riley, 36 U. S. App., 100, 16 C. C. A., 610, and 70 Fed. 32 namely, that in a suit brought to foreclose a mortgage lien upon the property of a quasi public corporation, it is competent for a court of equity to award a preference to a claim for property supplied or services rendered to such corporation, when it appears that the property so supplied or the services rendered were necessary to enable the company to discharge its public obligations and remain a going concern, and when it is evident that the property or services in question enhanced the value of the mortgaged property, and thereby inured to the benefit of the mortgagees."

Ninth Circuit—

In the Circuit Court of Appeals for the Ninth Circuit, in the case of New York Guaranty & Indem. Co. vs. Tacoma Ry. & M. Co., 83 Fed., 365, the court said (pages 369, 370):

"The question here is not so much whether the cable involved in this claim for preference is to be regarded in the light of repairs, or for construction, or as an improvement, or in the nature of materials or supplies furnished; but it depends upon the inquiry whether or not it was necessary to keep the road 'a going concern,' within the meaning of this expression as it is used by the Supreme Court in the cases cited above.

"It is further contended that the claim in question is in the nature of a claim for repairs and improvements, and that, to make out a case for preference, there must have been some diversion of income, which otherwise would have been applied, or was properly applicable, towards the payment of the claim, to payment of bonded interest, or otherwise to

the benefit of the security (citing Farmers Loan & Trust Co. vs. Northern Pac. R. Co., 68 Fed., 36, 37). But, to use the language of Judge Caldwell, in Farmers Loan & Trust Co. vs. Kansas City, W. & N. W. R. Co., 53 Fed., 182-189:

"'And it is error to suppose that such debts can only be given priority where there has been a diversion of the income of the road. Nor is it true that they can only be paid out of the earnings of the road, and can not be made a charge on the corpus of the property. A diversion of the income is not essential to give them priority, and they may be made a charge on the corpus of the estate if the earnings are not sufficient to pay them (citing Miltenberger vs. Railway Co., 106 U. S., 286-311, 312; Union Trust Co. vs. Illinois M. Ry. Co., 117 U. S., 434-457; Thomas vs. Railway Co., 36 Fed., 808')".

(c) This court has in two cases distinctly recognized the same principle, namely, that a diversion of earnings is not a condition precedent to the payment of current operating expenses out of the corpus of the property, and that this equity rests mainly upon two grounds: first, the duty which the railroad company owes to the public to keep the road going for the public use and benefit; second, the benefit which the bondholders derive in keeping up the railroad as a going concern, thus enabling it to maintain its property intact and its earning power unimpaired, and preventing a forfeiture of its franchises. To these may be added, that the sudden intervention of the court in taking possession of the railroad property deprives the company of the power of paying these supply claimants either out of its future earnings or by money raised upon its own credit; and also that the trustee of the bondholders in this case allowed the company to continue in possession of its property for more than a year after default in interest, and to incur these obligations, and finally procured the appointment of a receiver upon condition that these claims should be paid by the receiver out of borrowed money secured by a lien on the property.

In Miltenberger vs. Logansport Railway Co., 106 U. S., 286, $10,000.00 due other connecting lines of road for materials and repairs and for ticket and freight balances by the company prior to the receivership were paid out of the corpus of the property. It does not appear from the statement of the case, or from the language of the opinion which was delivered by Mr. Justice Blatchford, that there had been any diversion of earnings either by the company or by the receiver in favor of the bondholders. It does appear that an extension of six miles and a bridge constructed by the receiver under the order of the court were not paid for out of earnings, because their cost was made a charge upon the corpus of the property. There is nothing in the language used by Mr. Justice Blatchford to indicate that the court deemed a diversion of earnings in favor of the bondholders as necessary to make the amount due for materials and repairs and ticket and freight balances a charge upon the corpus of the property; on the contrary, the language of the opinion indicates clearly that the court deemed such a charge proper as based upon the equity arising solely from preserving and maintaining the road as a going concern. Mr. Justice Blatchford said (pp. 311, 312):

"It can not be affirmed that no items which accrued before the appointment of a receiver can be allowed in any case. Many circumstances may exist which may make it necessary and indispensable to the business of the road and the preservation of the property, for the receiver to pay pre-existing debts of certain classes, out of the earnings of the receivership, or even the corpus of the property, under the order of the court, with a priority of lien. Yet, the discretion to do so should be exercised with very great care. The payment of such debts stands, prima facie, on a different basis from the payment of claims arising under the receivership, while it may be brought within the principle of the latter by special circumstances. It is easy to see that the payment of unpaid debts for operating expenses, accrued

within ninety days, due by a railroad company suddenly deprived of the control of its property, due to operatives in its employ, whose cessation from work simultaneously is to be deprecated, in the interests both of the property and of the public, and the payment of limited amounts due to other and connecting lines of road for materials and repairs, and for unpaid ticket and freight balances, the outcome of indispensable business relations, where a stoppage of the continuance of such business relations would be a probable result, in case of nonpayment, the general consequence involving largely, also, the interests and accommodation of travel and traffic, may well place such payments in the category of payments to preserve the mortgaged property in a large sense, by maintaining the good will and integrity of the enterprise, and entitle them to be made a first lien. This view of the public interest in such a highway for public use, as a railroad is, as bearing on the maintenance and use of its franchises and property in the hands of a receiver, with a view to public convenience, was the subject of approval by this court, speaking through Mr. Justice Woods, in Barton vs. Barbour, 104 U. S. 126. The appellants furnish no basis for questioning any specific amounts allowed in respect of the arrears referred to, but object to the allowance of anything out of the sale of the corpus for such expenditures. Under all the circumstances of the case, we see no valid objection to the provisions of the orders complained of."

This case was cited approvingly in Union Trust Co. vs. Illinois Midland Co., 117 U. S. 434. In that case wages due employes of the railroad within six months immediately preceding the appointment of the receiver were allowed priority out of the corpus of the property. Mr. Justice Blatchford again delivered the opinion of the court. It does not affirmatively appear whether there had been any diversion of earnings by the company in favor of the bondholders, but there is no allusion to that fact as necessary to the granting of a lien upon the corpus of the property, although there is a discussion of the diversion of a portion of the income of the receivership to "betterments" upon the property which

necessitated the issuance of receiver's certificates charged upon the corpus to make good this diversion of earnings as the operating expenses of the receivership were greater in amount than the sum thus diverted, and a portion thereof remained unpaid. (See pp. 462-3.) That there was no final diversion of earnings during the receivership is shown by charging a portion of the receiver's operating expenses upon the corpus, after the diversion for betterments had been provided for (See pp. 464-5.)

From a careful reading of both of these opinions one is irresistibly led to the opinion that the court did not consider a diversion of earnings either by the company or the receiver in favor of the bondholders as necessary to create a lien upon the corpus of the property in favor of claims for labor and supplies absolutely necessary to keep the road a going concern.

Is it true that a party furnishing to a railroad company supplies necessary for ordinary repairs to and the daily operation of the road, looks necessarily to the income as the only means by which he can be paid for these supplies?

If the income of a railroad is notoriously insufficient to pay the expenses absolutely necessary to enable it to fulfill its public functions as a common carrier, can it be said that a party furnishing supplies necessary to maintain it as a going concern looks exclusively to this income for his payment?

If so, it necessarily follows that in such a case no supplies can be furnished at all and that the company can not fulfill its public functions unless either by its own motion, a practice which is certainly not to be commended, or by the adverse action of some creditor, a court of equity is appealed to for the appointment of a receiver.

Take the case of a train thrown off the track by reason of the rails having spread because the ties were rotten. Is the wreck to be left until a receiver is appointed because there

is no means of making payment of the cost of its removal unless the company happens to have the cash in hand and offers to pay the laborers their wages for restoring the road to its prior condition? This is no doubt an extreme case but extreme cases sometimes indicate principles. Can any one doubt that, if the laborers had in fact trusted the company for their payment and had performed the work necessary to remove the wreck and put the rails back in position so that the road might be operated, and the next day a receiver had been appointed, their claims would be held by this court under the authority of the Miltenberger and Illinois Midland cases, valid liens upon the corpus of the property superior to the lien of the mortgagees even if there had been no diversion of earnings by the company? Would not payments of this character from the corpus of the property be, to quote the language of Mr. Justice Blatchford in the Miltenberger case: "Payments in the category of payments to preserve the mortgaged property in a large sense by maintaining the good will and integrity of the enterprise and entitle them to be made a first lien?" The court below evidently thought so for it ordered "wages, traffic balances, materials and supplies" furnished within six months of the receivership and remaining unpaid when the receiver was appointed in the case at bar to be paid by the receiver out of the proceeds of receiver's certificates which were made a charge upon the corpus of the property. (R. pp. 23, 27.)

Some of these claims were paid, but for some reason never explained the order was modified, and others were left unpaid.

If the claims of the laborers may be preferred, may not the claims of those who furnished sound ties to replace the rotten ones also be preferred? In the case supposed, in order to maintain the track in place after the wreck had been

removed sound ties would have been indispensable. Is the claim for an indispensable cross tie supplied to a company any the less entitled to equitable consideration than the claim of the indispensable laborer who puts the indispensable cross tie into its proper place?

They must stand upon an equal footing, and either neither can be given preference or both are equally entitled to priority.

If the doctrine of this court upon the question of priority in favor of current supply claimants over mortgage bondholders had been limited to cases where there had been a diversion of earnings by the company in favor of the bondholders, and that what these latter had inequitably received they must restore, the equity would have been apparent. This is the doctrine of Fosdick vs. Schall, 99 U. S. 235. But this court has not limited itself to the granting of priority in such cases only, but has extended the equity to cases where there has been no diversion of earnings by the company whatever.

It has admittedly extended it to cases where the supply claimants are entitled to be paid from the surplus income of the receivership, and if this has been diverted in favor of the bondholders, then out of the corpus of the property.

It has extended it also to cases where, "while the company is operating its road its income is misappropriated and diverted to purposes which do not inure to the benefit of the mortgage bondholders and are foreign to the beneficial maintenance, preservation and improvement of the property," to quote the language of Mr. Justice White, in V. & A. Coal Co. vs. Central Railroad Co., 170 U. S. 355, 365.

Until the mortgage bondholders take possession of a railroad either directly under the powers conferred upon the

trustee in the mortgage or by the intervention of a court of equity in the appointment of a receiver, the bondholders have no rights in the income of the road although that income has been mortgaged to them. When, however, they do exercise their contractual rights and do take possession of the road, why are they not entitled to the income thereafter accruing to the exclusion of the supply claimants unless the income during the time the road was operated by the company was diverted from the payment of supply claims to the bondholders' benefit? This court has answered this by saying that the bondholders are only entitled to the net income, and that the intervention of the court has deprived the company of its means of paying those expenses which are primarily a charge upon its gross income, and the court must do what the company would have done if let alone.

But, even if this is so, wherein lies the equity of imposing a burden upon the bondholders by depriving them of their contractual rights in the income or in the corpus if that income is diverted by the receiver, in a case where before they had any legal right to interfere the income of the company was diverted by the company without any power of the bondholders to control it to purposes "foreign to the beneficial maintenance, preservation and improvement of the property" so as not to inure to their benefit?

What difference in such a case is there between their rights in the income and their rights in the corpus? The company certainly in the case where there had been no long previous default in the payment of the mortgage interest authorizing the bondholders to intervene and sequestrate the income, was not the agent of the bondholders in thus diverting the earnings. Upon what principle of equity then is it, in such a case, that a supply claimant has a claim upon the earnings of the receivership superior to the mortgages? It is said that a person furnishing supplies to a railroad company which he

knows to be mortgaged can not expect to receive payment out of the corpus of the property other than that which is left after liquidating the mortgage debts and that he contracts with the company with that understanding. But, if the mortgage also covers income, he knows that the income may be secured by the mortgagee in the event that the company fails to pay interest. Why does he not then also contract with the understanding that, if the mortgagee exercises his legal rights, he will also be deprived of payment from the earnings which the company were unable to obtain because of the legal intervention of the bondholders?

We respectfully submit that in such a case the court has exercised its power to prefer one class of creditors over another class of creditors, when the equity of the one given the legal right is of equal rank except upon the theory that the supply claimant has done something for the property by keeping it a going concern, which makes it more valuable to the bondholder and enables the company to fulfill its public duties; and if so, then his rights in the corpus are as great as his rights in the income. Such we understand to be the principle decided in the Miltenberger and Illinois Midland cases.

It must be remembered that we are not treating of strict legal rights. The supply claimant has no such rights either in the corpus or the earnings, while the bondholders have such legal rights both in the corpus and the earnings. We are considering equitable rights—those which appeal to the conscience of a chancellor and which demand that he shall do justice. If there are surplus earnings the court of equity takes these earnings away from the bondholder, who at law is entitled to them, and gives them to the supply claimant, because the court deems the latter equitably entitled to them. If there are no such earnings and the supply claimant has preserved the property and kept it a "going concern" so that it may continue to fulfill its public functions and maintain its

value for the benefit of the bondholders, why may he not be entitled to the same equity of payment from the corpus of the property as he is in the case of earnings from those earnings? In each case legal rights are impaired and in each case there has been the same preservation of the railroad as a going concern for the benefit of the bondholders and the same maintenance of the highway for the public use.

In its last analysis, there is no difference between the equity of the supply claimant in the corpus from his equity in the earnings. Such was the decision of this court in the Miltenberger and Illinois Midland cases, and the language of the opinions in various other cases, where it has been said that this equity will be given "in the corpus of the property." This certainly is the view of the judges of the inferior federal courts, whose opinions we have quoted above, and notably the opinion of Mr. Chief Justice Fuller in Finance Co. vs. Charleston, C. & C. R. R., 62 F. R. 205, on page 208; and of Judge Putnam in New England R. R. Co. vs. Carnegie, 75 F. R. 54 on page 59.

This court has never refused to pay supply claimants out of the corpus, on the ground that there has been no diversion of earnings; and has never formulated any such doctrine; nor have its decisions been construed as formulating any such doctrine except by the Circuit Court of Appeals for the Sixth Circuit. Four other courts of equal jurisdiction have interpreted its decisions as being quite the contrary.

The only cases in this court in which a charge against the corpus of the property has been denied are the following:

Fosdick vs. Schall, 99 U. S., 235.

Huidekoper vs. Locomotive Works, 99 U. S., 258.

Penn vs. Calhoun, 121 U. S., 251.

St. Louis, etc., R. R. vs. Cleveland, etc., R. R., 125 U. S., 658.

Kneeland vs. Amer. Loan Co., 136 U. S., 89.
Morgan's Co. vs. Texas Central Ry., 137 U. S., 171.
Louisville, etc., Railroad Co. vs. Wilson, 138 U. S. 501.
Thomas vs. Western Car Co., 149 U. S. 95.

None of these cases involved claims for supplies furnished or labor rendered to a railroad company necessary to maintain the railroad from day to day as a going concern.

Fosdick vs. Schall, Huidekoper vs. Locomotive Works, Kneeland vs. American Loan Co. and Thomas vs. Western Car Co. were all cases on leasing of rolling stock. The principle upon which all the rolling stock cases are decided is that the conditional vendor, having retained a lien upon particular property, is limited to the lien on that particular property, and if he recovers that property he is not in equity entitled to make an additional charge against the realty. If, on the other hand, the particular property is taken for the benefit of the realty, and sold with the realty, then the lien on the particular property having been absorbed in the general property, he is entitled, by way of subrogation, to payment from the proceeds of the whole property.

Penn vs. Calhoun and Morgan's Co. vs. Texas, etc., were claims for money loaned to the railroad company. The lenders were rightly held to be unsecured creditors merely.

In St. Louis, etc., R. R. Co. vs. Cleveland, etc., R. R., the claim was for rent of a leased line. It is manifest that the operation of a leased line is not necessary to maintain as a going concern the main line of the lessee company.

Louisville R. R. Co. vs. Wilson was a claim for attorney fees. Clearly attorneys' services are not indispensably necessary to enable a railroad to perform its public functions.

SECOND POINT.

All the six months' claimants are entitled to the same treatment, especially in this case.

The original order appointing the receiver was made on June 2, 1897, the same day the bill was filed, at the instance of the Mercantile Trust Company, trustee of the first mortgage bondholders. Presumably the receiver was appointed because the trustee and the company agreed to its conditions and its terms. It authorized the receiver, among other things, "to pay the employees, officials and other persons having claims for wages, services, materials and supplies due and to become due and unpaid growing out of the operation of the railroad of the defendant, including current and unpaid vouchers;" and for that purpose to borrow such sums of money as might be necessary, not exceeding $35,000.00, but to pay no claims against the railway company which had accrued due more than six months prior to the date of the order (Rec. pp. 23-4).

Subsequently on June 7, 1897, the receiver represented to the court; that there were certain obligations and indebtedness which had been incurred by the railroad company in the maintenance and operation of the railroad prior to his appointment, which indebtedness it was necessary to pay in order to further operate and maintain the railroad in the performance of its duty as a common carrier under the law and in the carrying on of its business; that said indebtedness was for labor performed by its employees, for maturing and matured car trusts, for traffic balances, for interest on terminal property, for rental, for taxes, for materials and supplies furnished said railroad company, and for obligations incurred in the maintenance and operation of said railroad during a period of six months next preceding the receivership; that the aggregate of such obligations exceeded $200,000.00 and that it would require said sum in order to pay such obliga-

tions; that it was for the best interests of the bondholders of said railroad and of other persons interested therein that such obligations should be paid as speedily as possible; and that, as he was unable to meet such obligations from the operation of the railroad, he asked the authority of the court to borrow money and issue receivers' certificates in the amount of $200,000.00 for that purpose (Rec. 26).

On the same day, June 7th, 1897, the court made an order authorizing the receiver to borrow $200,000.00 and issue his receivers' certificates therefor for the purpose of paying the obligations referred to and made them a charge upon the earnings of the receivership and the proceeds of the sale of the property (Rec. 27).

A month afterwards, on July 7th, 1897, the receiver, being represented by one of counsel, who had signed the original bill of complaint of the Mercantile Trust Company and no one else except the trustee of the second mortgage being represented, filed a supplemental application in which he asked authority to apply $30,000.00 of the proceeds of $200,000.00 of receivers' certificates to the acquirement of certain real estate; and further represented that he had used $35,000.00 to pay the wages which had accrued prior to the receivership, and asked that he might be authorized to apply the remaining $135,000.00 in paying car trust obligations, accruing pay rolls and necessary repairs. On the same day an order was made to that effect (Rec. 32).

The result of this was that of the $200,000.00 authorized to be borrowed June 2d and June 7th, and for which receivers' certificates were issued, $35,000.00 was used to pay wages which had accrued prior to the receivership and the remaining $165,000 was diverted for permanent improvements. The other six months' claimants were left unpaid.

This anomalous proceeding was at the express instance of the Mercantile Trust Company and its receiver. It had

originally procured the appointment of a receiver, and authority to issue receivers' certificates on an entirely different basis, and by an order in which it had provided for the payment of these claims and the borrowing of money for that purpose charged on the corpus of the property.

The subsequent action of the court at the instance of the receiver and the trust companies in modifying the original authority to borrow money to pay supply claimants of the class of which Mr. Gregg forms a part, while leaving intact the power to borrow money to pay the pay-rolls of the company for the two months prior to the receivership, has resulted in the payment of the laborers and employes of the company for services rendered to it prior to the receivership from the proceeds of receivers' certificates which have been decreed by the court to be paid from the proceeds of the sale prior to the mortgage bondholders.

The claims of these laborers and employes for their wages for the services rendered to the company prior to the receivership have no superior equity to the claims of those furnishing supplies during the same time necessary to maintain the railroad from day to day as a going concern. By modifying the original orders part of a class of creditors, all of whose claims stood upon an equal footing as to the lien of the mortgage bondholders, has been paid out of the corpus of the property, thus making their claims prior to the lien of the mortgage bondholders, while the other part of the same class have had their claims postponed and made junior to the same lien of the bondholders. Why should the Mercantile Trust Company as trustee be allowed to change the terms of the orders under which the receiver was appointed and use the proceeds of receivers' certificates to make permanent improvements after having gotten a receiver appointed upon condition that supply claimants should be paid?

This should not be done. Equity requires that the supply claimants whose claims have been thus postponed by the

court should be put upon an equal footing with the claims of the laborers who have been paid.

As was said by Judge Putman in New England R. Co. vs. Carnegie Steel Co., 75 F. R., 54, on page 57:

"It appears that, pursuant to the decree, many claims of the class of the petitioner's were paid by the receivers. Indeed, so far as the record goes, this is the only one unpaid. This would not be equity if the petitioner should ultimately fail of recovery, as equity demands equal distribution among all of the same class."

Even if the claims of those furnishing supplies to a railroad immediately before a receivership are not entitled to a lien upon the corpus of the property prior to that of the mortgage bondholders, in this case the action of the trustee in waiting over a year after default in interest before applying for a receiver, and then procuring a receiver by an order directing, as an incident to the appointment of a receiver, the claims to be paid, and allowing a part of the claims of a class only equal in lien and equity to those of Gregg and the other supply claimants to be paid thereunder, now entitles these postponed claimants to be paid from the corpus of the property, thus putting all of the same class of creditors upon an equality.

The original orders appointing the receiver, and directing these claims to be paid, and authorizing him to borrow funds sufficient for that purpose, were made either at the instance of the trustee of the first mortgage, and on its application for a receiver, or on the application of the receiver himself.

As said by the Supreme Court in Fosdick vs. Schall, 99 U. S., 235-253:

"The mortgagee has his strict rights which he may enforce in the ordinary way. If he asks no favors he need grant none; but if he calls upon a court of chancery to put forth its extraordinary powers and grant him purely equitable relief, he may with propriety be required to submit to the

operation of a rule which always applies in such cases, and do equity in order to get equity. The appointment of a receiver is not a matter of strict right. Such an application always calls for the exercise of judicial discretion, and the chancellor should so mold his order that, while favoring one, injustice is not done to another. If this can not be accomplished the application should ordinarily be denied."

While this doctrine was abused to such an extent as to call forth a sharp reprimand from this court in Kneeland vs. the American Loan Co., 136 U. S., 89-97, still it must within proper limits be treated as the equitable rule. If, as in the Miltenberger case, 106 U. S. 286, claims of the character of the one at bar were paid out of the corpus against the objection of the first mortgagee, it is not asking too much that the original order of the court made at the instance of the first mortgagee should be carried out. Even had the orders not been originally made directing the payment of the claims at bar, still the court might have subsequently provided for their payment.

Fosdick vs. Schall, 99 U. S., 235-253.

Carnegie Steel Co. vs. N. E. R. R. Co., 79 Fed., 741.

Finance Co. vs. the C. & C. R. Co., 62 Fed., 205.

A fortiori, should such an order, which has been partly carried out, have been enforced by the court below as to all claimants of the same class. The trustee of the bondholders should not be allowed to change its attitude and switch the proceeds of receivers' certificates to the permanent improvement of the property.

THIRD POINT.

The suggestion that the petitioner Gregg had a claim against another fund, namely, the surplus earnings of the receivership, is without weight.

(a) In answer to the petition for the writ of certiorari, a suggestion was made by the respondents that the petitioner had a claim against another fund, namely, the surplus earn-

ings of the receivership. The statement was also volunteered that there were such surplus earnings, although it was accompanied with a disclaimer that the record showed any such fact.

If the record shows no such fact, the statement should not have been made. The record shows no such fact. So far as the record speaks at all on the matter, it shows the exact contrary to be the fact.

The order authorizing the issue of the $200,000.00 of receivers' certificates to pay six months' supply and other claims made the amount of these certificates a charge upon any surplus earnings of the receivership first after such payments as might be necessary in the operation of the railroad (Rec. 28).

As all the receivers' certificates were paid out of the proceeds of the sale of the property it is fair to presume that there were no surplus earnings of the receivership. The decrees of the lower court bear this out. The original final decree and order of sale made March 10th, 1900, found that $1,043,251.54 of receivers' certificates had been issued; that they were a valid and subsisting lien upon all the property; and "that in addition to the aforesaid receivers' certificates a large amount of indebtedness has been incurred by the receivers appointed in this cause;" that neither the railroad company nor the receivers had the means to pay this indebtedness; and that it was necessary for the protection of the creditors of the receivers and the holders of their certificates to sell the property (Rec. 161).

The later decree of November 25th, 1901, is to the same effect (Rec. 210).

In the decree of confirmation and distribution the receiver's certificates were ordered to be paid out of the proceeds of the sale prior to the bondholders (Rec. 326).

These decrees were all taken, the railroad sold and the proceeds of the sale distributed without any reference to any

surplus earnings of the receivership and even before the receivers had accounted (Rec. 333).

The supply claimants protected themselves in their claims against the proceeds of sale by having some of these proceeds set aside to meet their claims and by an appeal (Rec. 327-8). Had they not done so the fund to which they looked would have been distributed.

It is true that out of abundant caution they reserved any rights they might have against the receivers' surplus earnings should there ever prove to be any. So far as the record shows there not only were no surplus earnings but in addition to over $1,000,000.00 of receivers' certificates "a large amount of indebtedness" had been incurred by the receivers.

(b) Even had there been surplus earnings of the receivership the fact that the supply claimants had a claim against such a fund would not have precluded them from pursuing their claim, if they have a claim for any of the reasons heretofore given, against some other fund, namely, the proceeds of the sale of the property.

(c) And even were there surplus earnings which were primarily liable for the payment of supply claims and the corpus, if liable for any reason only secondarily liable, if the latter fund pays the claims, those interested in the proceeds of the sale, which have been reserved by the court to meet such supply claims, can be fully protected by reimbursement from such surplus earnings, if called upon to pay such claims.

FOURTH POINT.

The Special Equity for $3,200.

The receiver was appointed June 2, 1897.

The stipulation between the parties shows that during the month of May and on the 1st, 2d and 3d days of June, 1897, there were sold and delivered to the C., S. & H. R. R. Co. ties of the value of $4,709.53, payment for which would

have been due on the 25th of June, 1897, and that an inventory taken by the receiver on the 10th of June, 1897, showed that of the ties so sold and delivered there were on hand upon said date ties to the amount and value of $3,200, which said receiver thereafter used in the operation and maintenance of said railroad as a going concern. (Record, 158).

Upon these facts the appellant, in any view of this case, is entitled to be paid out of the proceeds of the sale prior to the mortgage bondholders the sum of $3,200, being the value of the ties on hand when the receiver made his inventory, which were sold and delivered a few weeks before and on the day preceding and following the appointment of the receiver, which the receiver used and which thus inured to the benefit of the bondholders.

The ground of this contention is that the purchase of the ties by the railroad company at a time when it was, as it knew, hopelessly insolvent and had no reasonable expectation of paying therefor, and after it had defaulted on the interest due upon its bonds, was a fraudulent purchase which would have entitled Gregg, had the ties not been in the possession of the court, to have retaken them, and which would have entitled and justified the court to order their re-delivery to him, or in default thereof, payment therefor.

Donaldson Assignee vs. Farwell, 93 U. S., 631.
Wimot vs. Lyon et al., 49 Ohio St., 296.
Talcott vs. Henderson, 31 Ohio St., 162.
Morrow vs. New England Stove Co., 57 Fed., 693.
Davis et al. vs. Stewart, 8 Fed., 803.
Jaffray vs. Brown, 29 Fed., 476.

Another consideration is that Gregg could and doubtless would have asked for the re-delivery of the ties upon this ground, had the orders of June 2 and June 7, 1897, appointing the receiver and authorizing the borrowing of $200,000 not directed the payment of this claim.

In his intervening petition, Gregg called attention to the fact that a large part of the ties had been used by the receiver, after his appointment, in the operation and maintenance of the road, and it is so stipulated between the parties (Rec. 37, 39, 146). A special equity under the circumstances entirely apart from any question of diversion arose as to these $3,200 worth of ties. A court of equity should reimburse him therefor under the circumstances.

This court has recognized special equities entirely apart from any question of diversion.

St. L., etc., R. R. vs. Cleveland, etc., Ry., 125 U. S. 658, 673.

Union Trust Co. vs. Souther, 107 U. S. 598.

Morgan vs. T. C. R. Co., 137 U. S. 171, 197.

FIFTH POINT.

The decree below should be reversed.

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